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TO: Commissioners, Directors and Superintendents of NAIC Member Jurisdictions

FROM: NAIC Reinsurance (E) Task Force

DATE: March 15, 2009

SUBJECT: Guidance Regarding Reinsurance Collateral Requirements

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Concern has been expressed to NAIC members that current conditions in the financial markets are presenting challenges as U.S. ceding insurers seek to obtain sufficient collateral to secure reinsurance recoverable balances from unauthorized assuming insurers. Current reinsurance law requires that these balances be appropriately collateralized in order for a U.S. ceding insurer to receive credit for reinsurance in the statutory financial statements. Particular areas of concern that have been raised are a potential reduced supply of letters of credit (LOC) due to credit contraction by U.S. banks, and diminished trust account balances resulting from a general decline in the values of trust assets.

As these concerns have been communicated, many members have also been presented with proposals to consider a variety of alternative collateral arrangements. This has resulted in requests for clarification regarding the authority granted to commissioners under the NAIC Credit for Reinsurance Model Law (Model Law) and the Credit for Reinsurance Model Regulation (Model Regulation) to accept “any other form of security acceptable to the commissioner,” and to determine that a financial institution meets the criteria to be considered a “Qualified U.S. Financial Institution” for the purposes of issuing or confirming LOCs or for holding assets in trust on behalf of a U.S. ceding company.

In an effort to assist our members as questions and proposals are considered, the NAIC determined that it would be beneficial to distribute general guidance to commissioners regarding the application of this authority. Please note that this guidance is not intended to be binding interpretation, nor is it intended to amend existing law or expand current practices. Also, please note that not all jurisdictions grant this authority within their respective laws to the same extent as is allowed under the Model Law and Model Regulation. As such, each jurisdiction’s applicable laws should be reviewed during consideration of the general guidance provided within this memorandum.

The provisions of the Model Law and Model Regulation were thoroughly contemplated through a well-thought-out, conservative and deliberate process. Therefore, caution should be used when considering expansion of these provisions as a response to current circumstances. Due to the importance of case-by-case evaluation of each proposal, it is not practical or feasible to provide an exhaustive list of items which have been, or could be considered acceptable. Regulators’ analysis of any arrangement that is considered for acceptability should include, but not be limited to, consideration of the following guidance.

Subsequent to issuance of this guidance letter, the NAIC will consider the development of a reporting mechanism to facilitate communication among NAIC members in situations where forms of security other than those specifically included in the Model Law and Model Regulation have been accepted.



## **Guidance on Reinsurance Collateral Requirements**

Section 3 of the Model Law provides the following:

### **Section 3. Asset or Reduction from Liability for Reinsurance Ceded by a Domestic Insurer to an Assuming Insurer not Meeting the Requirements of Section 2**

An asset or a reduction from liability for the reinsurance ceded by a domestic insurer to an assuming insurer not meeting the requirements of Section 2 shall be allowed in an amount not exceeding the liabilities carried by the ceding insurer. The reduction shall be in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the ceding insurer, under a reinsurance contract with the assuming insurer as security for the payment of obligations there under, if the security is held in the United States subject to withdrawal solely by, and under the exclusive control of, the ceding insurer; or, in the case of a trust, held in a qualified U.S. financial institution, as defined in Section 4B. This security may be in the form of:

- A. Cash;
- B. Securities listed by the Securities Valuation Office of the National Association of Insurance Commissioners and qualifying as admitted assets;
- C.
  - (1) Clean, irrevocable, unconditional letters of credit, issued or confirmed by a qualified U.S. financial institution, as defined in Section 4A, effective no later than December 31 of the year for which the filing is being made, and in the possession of, or in trust for, the ceding company on or before the filing date of its annual statement;
  - (2) Letters of credit meeting applicable standards of issuer acceptability as of the dates of their issuance (or confirmation) shall, notwithstanding the issuing (or confirming) institution's subsequent failure to meet applicable standards of issuer acceptability, continue to be acceptable as security until their expiration, extension, renewal, modification or amendment, whichever first occurs; or
- D. Any other form of security acceptable to the commissioner.

Section 9 of the Model Regulation provides the following:

### **Section 9. Asset or Reduction from Liability for Reinsurance Ceded to an Unauthorized Assuming Insurer not Meeting the Requirements of Sections 4 Through 8**

- A. Pursuant to Section [cite state law equivalent of Section 3 of the Credit for Reinsurance Model Law], the commissioner shall allow a reduction from liability for reinsurance ceded by a domestic insurer to an assuming insurer not meeting the requirements of Section [cite state law equivalent of Section 2 or other appropriate section of the Credit for Reinsurance Model Law] in an amount not exceeding the liabilities carried by the ceding insurer. The reduction shall be in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the exclusive benefit of the ceding insurer, under a reinsurance contract with such assuming insurer as security for the payment of obligations under the reinsurance contract. The security shall be held in the United States subject to withdrawal solely by, and under the exclusive control of, the ceding insurer or, in the case of a trust, held in a qualified United States financial institution as defined in Section [cite state law equivalent of Section 4B of the Credit for Reinsurance Model Law]. This security may be in the form of any of the following:

- (1) Cash;
- (2) Securities listed by the Securities Valuation Office of the NAIC and qualifying as admitted assets;
- (3) Clean, irrevocable, unconditional and "evergreen" letters of credit issued or confirmed by a qualified United States institution, as defined in Section [cite state law equivalent of Section 4A of the Credit for Reinsurance Model Law], effective no later than



December 31 of the year for which filing is being made, and in the possession of, or in trust for, the ceding company on or before the filing date of its annual statement. Letters of credit meeting applicable standards of issuer acceptability as of the dates of their issuance (or confirmation) shall, notwithstanding the issuing (or confirming) institution's subsequent failure to meet applicable standards of issuer acceptability, continue to be acceptable as security until their expiration, extension, renewal, modification or amendment, whichever first occurs; or

(4) Any other form of security acceptable to the commissioner.

B. An admitted asset or reduction from liability for reinsurance ceded to an unauthorized assuming insurer pursuant to this section shall be allowed only when the requirements of Section 13 and the applicable portions of Sections 10, 11 and 12 of this regulation have been satisfied.

Section 12 of the Model Regulation provides the following:

**Section 12. Other Security**

A ceding insurer may take credit for unencumbered funds withheld by the ceding insurer in the United States subject to withdrawal solely by the ceding insurer and under its exclusive control.

- So long as the credit for reinsurance law in a jurisdiction provides this authority to the same extent granted to commissioners under Section 3(D) of the Model Law and Section 9(A)(4) of the Model Regulation, it is the opinion of the NAIC that commissioners should utilize this authority on a case-by-case basis only after careful and thorough evaluation of all information relevant to each situation.
- Section 3 of the Model Law and Section 9(A) of the Model Regulation requires any security to be held in the United States subject to withdrawal solely by, and under the exclusive control of, the ceding insurer; or, in the case of a trust, held in a qualified U.S. financial institution, as defined in Section 4B of the Model Law, or the equivalent law of the respective jurisdiction.
- Security permitted under these sections should be provided for the sole benefit of the applicable ceding insurer.
- This authority is not intended to allow a ceding insurer to take credit in excess of the amount of collateral that is provided.
- LOCs should be limited to those issued or confirmed by “qualified U.S. financial institutions,” as defined within Section 4(A) of the Model Law, unless otherwise permitted by existing law and regulation.

**Guidance on Qualified U.S. Financial Institutions**

Section 4 of the Model Law provides the following:

**Section 4. Qualified U.S. Financial Institutions**

- A. For purposes of Section 3C, a “qualified U.S. financial institution” means an institution that:
- (1) Is organized or (in the case of a U.S. office of a foreign banking organization) licensed, under the laws of the United States or any state thereof;
  - (2) Is regulated, supervised and examined by U.S. federal or state authorities having regulatory authority over banks and trust companies; and
  - (3) Has been determined by either the commissioner or the Securities Valuation Office of the National Association of Insurance Commissioners to meet such standards of financial condition and standing as are considered necessary and appropriate to



regulate the quality of financial institutions whose letters of credit will be acceptable to the commissioner.

- B. A “qualified U.S. financial institution” means, for purposes of those provisions of this law specifying those institutions that are eligible to act as a fiduciary of a trust, an institution that:
- (1) Is organized, or, in the case of a U.S. branch or agency office of a foreign banking organization, licensed, under the laws of the United States or any state thereof and has been granted authority to operate with fiduciary powers; and
  - (2) Is regulated, supervised and examined by federal or state authorities having regulatory authority over banks and trust companies.
- An institution must meet the criteria within Sections 4(A)(1), (2) and (3) of the Model Law in order to be considered a “qualified U.S. financial institution” for the purposes of issuing or confirming an LOC under Section 3 of the Model Law.
  - The SVO maintains a list of U.S. financial institutions that have, upon application to the SVO, been determined to meet the eligibility standards within Part Ten of its *Purposes and Procedures Manual*. Though Section 4(A)(3) of the Model Law grants commissioners the authority to conduct such an evaluation, for the sake of uniformity there is a tendency among regulators to defer exclusively to the SVO for this analysis and to accept only those institutions currently included on the NAIC List of Banks when considering whether an institution is qualified to issue or confirm an LOC.
  - If an “unlisted” financial institution meets the provisions of Sections 4(A)(1) and (2) and will be providing collateral for a ceding insurer, a commissioner may require the financial institution to submit an application to the SVO for review. This process ordinarily takes approximately 30 days. Please see Attachment 1 for applicable information regarding these eligibility standards as well as information regarding the process for submitting application to the SVO for an entity to be considered for inclusion on the NAIC List of Banks.
  - It is important to note that the SVO process is not an evaluation of the terms of a particular LOC. Regulators should evaluate an LOC to verify that it meets the requirements within applicable law and regulation. Approval of an entity for listing on the NAIC List of Banks should not be considered an indication that any individual LOC meets required terms.

### **Additional Guidance Regarding LOCs**

Section 3(C)(1) of the Model Law and Section 9(A)(3) of the Model Regulation requires that an LOC be effective no later than December 31 in order for a U.S. ceding company to be able to receive credit for reinsurance for the related recoverables. However, these sections do allow a ceding company until the filing date of the annual statement to have the LOC in its possession or in trust.

Section 3(C)(1) of the Model Law provides the following:

Clean, irrevocable, unconditional letters of credit, issued or confirmed by a qualified U.S. financial institution, as defined in Section 4A, effective no later than December 31 of the year for which the filing is being made, and in the possession of, or in trust for, the ceding company on or before the filing date of its annual statement;

Section 9(A)(3) of Model Regulation provides the following:

Clean, irrevocable, unconditional and “evergreen” letters of credit issued or confirmed by a qualified United States institution, as defined in Section [cite state law equivalent of Section 4A of the Credit for Reinsurance Model Law], effective no later than December 31 of the year for which filing is being made, and in the possession of, or in trust for, the ceding company on or before the filing date of its annual statement. Letters of credit meeting applicable standards of issuer acceptability as of the dates of their issuance (or confirmation) shall, notwithstanding the issuing (or confirming) institution’s subsequent failure to meet applicable standards of issuer acceptability, continue to be acceptable as security until their expiration, extension, renewal, modification or amendment, whichever first occurs; or



## **Attachment 1**

*From the Purposes and Procedures Manual of the NAIC Securities Valuation Office*

### **Part Ten: Creation and Maintenance of Bank List**

#### **Section 1. List to be Compiled**

The staff is instructed to compile and maintain a list of banks that meet the credit standards identified in Section 2 below (Bank List). The Bank List may be used by state insurance departments for any purpose consistent with the NAIC Financial Conditions Framework, including, but not limited to, evaluation of the reinsurance credits claimed by ceding insurers and the determination of eligibility to serve as trustee for a nonadmitted insurer for purposes of the NAIC's International Insurers Department Plan of Operation and the NAIC's standard trust agreement. Inclusion on the Bank List does not imply an opinion of the suitability or unsuitability of those entities on the list to serve as providers of credit enhancement of securities.

#### **Section 2. Eligibility Standards**

##### **(a) Domestic Issuers**

Issuing or confirming banks may be placed on the Bank List if they meet the following requirements: the bank is authorized to issue or confirm bank letters of credit, is capable of performing the duties of a Trustee or both, and either (i) has an NAIC ARO rating of "Baa/BBB" or better for long-term debt or a "P2/A2" or better for short-term debt, or (ii) has the equivalent rating from a specialized securities rating company or service that is not an NAIC ARO.

##### **(b) Foreign Issuers**

U.S. Branches or agencies of foreign Letter of Credit issuers may be placed on the Bank List if they (i) issue letters of credit for reinsurance, (ii) are a part of foreign institution that (a) have attained an NAIC ARO rating of "Aa/AA" or better for long-term debt or a "P1/A1" or better for short-term debt by an NAIC ARO or (b) the equivalent rating by a securities rating company or service specializing in banks that is not an NAIC ARO.

##### **(c) General**

All standby letters of credit must be clean, irrevocable and unconditional. Additionally, these letters of credit must be issued or confirmed by, and must be presentable and payable at, an office of the qualifying bank located in the United States. Standby letters of credit issued by a foreign (non-U.S.) office of a qualifying U.S. institution must be confirmed by a United States office of the qualifying bank. The SVO does not review individual letters of credit and a bank's presence on the Bank List does not in any way imply that the requirements of this Section 2(c) have not been met.

#### **Section 3. Administration**

##### **(a) Reporting**

A party interested in having a bank listed on the Bank List should first determine whether the bank meets the minimum qualifications discussed above. If the bank meets the minimum qualifications discussed above, it should submit to the SVO:

- (i) An ATF Initial Filing Form; and
- (ii) A copy of its most recent Audited Financial Statement or call report; and



- (iii) Proof of current long and/or short-term rating from all NAIC AROs that have rated the bank, which may consist of:
  - (1) A copy of the rating letter from the NAIC ARO; or
  - (2) A copy of the page from the NAIC AROs rating publication showing the rating and the date of publication; or
  - (3) A copy of the Bloomberg display screen.

Upon receipt of the above documents and the filing fee, the SVO shall perform a financial review of the bank. Upon completion of that review, the applicant bank shall be informed in writing that it has been approved or disapproved for listing on the Bank List. Insurance companies that apply for reinsurance credit shall report the name of the issuer of the Letter of Credit to the SVO only if the issuer is not on the Bank List.

**(b) Monitoring and Updates**

Annually, the SVO shall contact by mail the banks then listed on the Bank List, inviting each bank to renew its listing by submitting the then application renewal fee and copies of the most recent Audited Financial Statements. The Bank List will be updated by the staff and disseminated as necessary to administer the intent of this Part. A bank on the Bank List that fails to provide the required documents and renewal fee or any bank whose credit quality has deteriorated to a level below the minimum standards identified above shall be deleted from the Bank List without notice.

**(c) Downgraded Banks**

Letters of credit issued by banks that have been removed from the Bank List after they have issued a Letter of Credit in support of a reinsurance contract shall be rated as if they were still on the Bank List until the initial expiration date of the letter of credit. The extension, renewal, modification or amendment of the letter of credit will only be recognized if the bank is re-listed on the Bank List. Restoration of a bank to the List will occur only after the bank has met the standards described above for five consecutive quarters.